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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1987

SHELL OFFSHORE, INC., *et al.*,
*Petitioners,*
v.
FEDERAL ENERGY REGULATORY COMMISSION,
*Respondent.*

SOUTHERN CALIFORNIA GAS COMPANY,
*Petitioner,*
v.
FEDERAL ENERGY REGULATORY COMMISSION,
*Respondent.*

**On Petitions for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit**

## BRIEF IN OPPOSITION OF TENNESSEE GAS PIPELINE COMPANY

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## BRIEF IN OPPOSITION OF TENNESSEE GAS PIPELINE COMPANY

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Five petitions for writs of certiorari seek review of discrete aspects of *Associated Gas Distributors v. FERC*, 824 F.2d 981 (D.C. Cir. 1987) (*AGD*). In No. 87-978, *Shell Offshore, Inc. v. FERC*, certain producers of natural gas ("Producers") jointly seek reversal of the court of appeals' remand for reconsideration of the Commission's refusal in FERC Order No. 436 to mitigate the impact on interstate pipelines' take-or-pay liabilities of requiring such pipelines to transport gas, as open-access carriers,

that displaces pipeline sales. Tennessee Gas Pipeline Company (Tennessee) opposes this petition.[1]

In No. 87-1091, *Southern California Gas Co. v. FERC*, a local distribution company (SoCal) seeks review of that portion of *AGD* that upholds alternative procedures adopted in Order No. 436 to expedite the approval of applications for certificates under section 7 of the Natural Gas Act (NGA), 15 U.S.C. § 717f, to provide new services and construct new facilities. Tennessee opposes SoCal's petition insofar as it requests an advisory opinion on the line of demarcation between interstate transportation of natural gas subject to the Commission's NGA jurisdiction and the local distribution of natural gas subject to regulation by the states.

## STATEMENT OF THE CASE

Take-or-pay provisions in gas supply contracts between interstate pipelines and producers of natural gas have led to serious "market disorders" in the natural gas industry since the enactment of the Natural Gas Policy Act (NGPA) in 1978.[2] Between 1978 and 1982, interstate gas pipelines, emerging from the severe shortages and curtailments of the 1970's, contracted for available gas reserves to meet customer requirements and replenish declining inventories.[3] Because the demand for

[1] Tennessee Gas Pipeline Company is a wholly-owned subsidiary of Tenneco Inc. Throughout this brief, references to the Appendix in No. 87-978 are cited as App. ——. Emphasis is supplied throughout this brief unless otherwise noted.

[2] The Commission so found when it initiated the rulemaking which led to the promulgation of Order No. 436. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Notice of Proposed Rulemaking, 50 Fed. Reg. 24,130 (1985), [1982-1987 Proposed Regs. Transfer Binder] F.E.R.C. Stats. and Regs. (CCH) ¶ 33,100 at 33,105-06 (1985).

[3] The Commission requires that pipelines maintain adequate supplies to meet their service obligations reflected in certificates issued pursuant to § 7 of the NGA. *See, e.g.*, United Gas Pipe Line Co.

reserves far exceeded supply, such reserves commanded the maximum lawful prices allowed by the NGPA for price-regulated gas and still higher prices for deregulated gas. Producers also typically obtained onerous quantity provisions, which obligated their pipeline-purchasers to take, or pay for, a very high percentage (typically 75 percent to 95 percent) of the producer's delivery capability. Interstate pipelines had no choice but to accept these burdensome terms in order to meet their contractual and certificated sales obligations to their customers:

> *All* the interstate pipelines bid supra-market prices for gas in 1978-82. A natural question is what would have happened to a pipeline that refused to do so. The answer is—Disaster. Any pipeline that limited its bids to true market prices would have found itself short of gas and almost certainly in breach of both contractual and regulatory duties to supply gas. With rolled-in prices and the NGPA system of wellhead price controls, it was a mathematical *necessity*, for the natural gas market to clear, that some gas be bought at prices above market levels.

Williams, *The Proposed Sea-Changes In Natural Gas Regulation*, 6 Energy L. J. 233, 237 (1985) (emphasis in original).

Since 1982, however, the gas market has moved from shortage to surplus. The Commission has traced the surplus to a decline in consumption caused by conservation, recession, loss of heavy manufacturing, fuel switching (due to the collapse of world oil prices)[4] and

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v. FERC, 597 F.2d 581, 588 (5th Cir. 1979), *cert. denied*, 445 U.S. 916 (1980); Amoco Production Co., 23 F.E.R.C. (CCH) ¶ 61,211 at 61,433 (1983).

[4] *See* Impact of Special Marketing Programs on Natural Gas Companies and Consumers, Notice of Inquiry, 49 Fed. Reg. 3193, IV F.E.R.C. Stats. & Regs. (CCH) ¶ 35,513 (1984).

a substantial increase in deliverability from existing reserves.[5] This surplus gas became available on the "spot market" at prices below the average cost of pipeline system supply under long-term contract. Order No. 436 allows producers to channel their uncommitted, surplus gas into pipeline sales markets at reduced prices. At the same time, producers demand that pipelines pay for gas that the pipelines are unable to take under existing higher-priced long-term contracts because the market has been displaced by the producers' lower-priced, surplus gas. Thus, Order No. 436 creates unprecedented, multi-billion dollar take-or-pay problems for interstate pipelines.[6] Therein lies the rub.

Order No. 436 restructures the natural gas industry by forcing interstate pipelines to become "open access" transporters of gas sold by producers to local distribution companies (LDCs) and end-users who previously relied almost exclusively on interstate pipelines for their gas supply.[7] However, Order No. 436 did not relieve inter-

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[5] The NGPA particularly spurred developmental drilling (that is, the drilling of new wells on existing reserves to increase production) rather than exploratory drilling for new reserves. *See* Notice of Inquiry, n.4, *supra*. For example, between 1978 and 1983, Transcontinental Gas Pipe Line Corporation's dedicated reserves increased by 3 percent, while deliverability under its supply contracts increased 140 percent. Hearings before the Subcomm. on Fossil and Synthetic Fuels of the House Comm. on Energy and Commerce, 98th Cong., 1st Sess. (October, 1983) (Statement of Brian O'Neill).

[6] Estimates of accrued take-or-pay in 1985 were approximately $7 billion. App. at 75a. Producers assert that Order No. 436 is resolving the problem. (Pet. Br. at 20) However, producers own figures underscore the severity of the problem. Despite having paid producers $200 million in 1985 and $700 million in 1986 plus non-cash concessions, pipelines continue to incur over $6 billion dollars of additional take-or-pay annually. The $700 million is just the tip of the iceberg.

[7] See the petitioners' statements of the case in Interstate Natural Gas Assoc. v. FERC, No. 87-976; Texas Eastern Transmission Corp. v. FERC, No. 87-977; and City of Willcox v. FERC, No. 87-979. These petitions seek review of the Order No. 436 open-access provi-

state pipelines of their traditional merchant role. Because of the Commission's concern for security of supply, pipelines are required to maintain a sufficient supply of gas to meet their certificated service obligations to their customers.[8] This, in turn, requires pipelines to maintain their long-term contracts with gas producers which contain provisions that obligate pipelines to pay for certain minimum volumes of gas whether or not taken. Pipeline customers, however, no longer are obligated to purchase a minimum amount of gas from their pipeline suppliers.[9] Thus, as explained previously, Order No. 436 allows producers to sell surplus "spot market" gas and other uncommitted supplies to pipeline customers while requiring pipelines to take or pay for long-term gas purchased to serve the same customers. Under current surplus conditions, producers have successfully displaced pipeline sales with spot market gas. Published reports estimate that nearly 70 percent of interstate gas transmission is transportation of gas for others rather than pipeline sales.[10]

In Order No. 436, the Commission refused to adopt affirmative remedies to mitigate the build-up of take-or-pay liability under producer-pipeline gas supply contracts caused by its open access transportation program. The Commission told pipelines to buy their way out of their obligations to producers and attempt to pass these payments downstream to their ratepayers in individual rate cases. *See* App. at 80a-85a. In so doing, the Commission

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sion on the ground that it reflects the unlawful imposition of common carriage on interstate pipelines.

[8] *See* the discussion at n.3, *supra*. Pipelines earn no profit on their gas inventories; they are required to resell their gas at cost.

[9] *See* Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1148 (1986) (affirming FERC Order No. 380, which required interstate pipelines to eliminate gas cost minimum bills from their rate schedules).

[10] Foster's Natural Gas Reports, Feb. 25, 1988 at 15.

made no real assessment of pipelines' abilities to arrange such buy-outs, the aggregate cost of pipelines' buying out of these obligations, the effect of such buy-outs on LDC supply security and the rate impact on ultimate consumers. Moreover, Order No. 436 removed the pipelines' principal bargaining chip to mitigate the cost of resolving take-or-pay problems—the ability to trade transportation for renegotiation of "problem" contracts. *See* App. at 81a.

On review of Order No. 436 in *AGD*, the court of appeals upheld the Commission's authority to impose open-access, common carriage obligations on interstate pipelines. However, it found that the Commission's treatment of the take-or-pay issue did not meet the requirement of "reasoned decisionmaking." The court of appeals identified the three premises upon which the Commission's refusal to act was based: (1) Order No. 436 would not cause take-or-pay liabilities to increase; (2) certain policy considerations militated against regulatory relief; and (3) the most obvious remedies (exercise of NGA § 5 power to modify unjust and unreasonable take-or-pay provisions, and limitations on open access with respect to producers that refused to cooperate in mitigating the impact of Order No. 436 on pipeline take-or-pay) were flawed. App. at 80a. It remanded Order No. 436 because the first and third premises were insupportable.

The court of appeals explained in great detail why it could not accept the Commission's assertion that Order No. 436 would not increase pipeline take-or-pay exposure and make it more difficult and expensive for pipelines to resolve these liabilities. App. at 80a-86a. It concluded that "FERC's seeming blindness to the possible impact of Order No. 436 on take-or-pay liability . . . seem[s] impossible to square with the requirement of reasoned decisionmaking. App. at 84a.

The court of appeals also found fatal weaknesses in the reasons offered by the Commission for rejecting the

major alternatives supported by virtually all state regulatory agency and LDC representatives. App. at 89a-94a. The court found the Commission's explanation of its rejection of section 5 action to be so unclear that meaningful review was impossible. App. at 90a. The court similarly found wholly implausible the Commission's assertion that any limitation on open access would be unduly discriminatory under the NGA. App. at 91a-92a. Thus, it remanded the case to the Commission for further explanation. App. at 124a.

## REASONS WHY THE WRITS SHOULD NOT BE GRANTED

### I. THE PRODUCERS' PETITION IS NOT RIPE FOR REVIEW

To be sure, Order No. 436 is of enormous significance to all segments of the natural gas industry. But that does not mean that all of the petitions raise issues that are worthy of review by this Court. Producers' petition differs sharply from the Interstate Pipeline petitions (cited in note 7) in its fitness for review by the Court. The open access regulations challenged by the Interstate Pipelines are final and in effect; their legality has been determined subject only to review by this Court.[11] By contrast, the court of appeals did not finally determine that the Commission was required to adopt specific take-or-pay mitigating measures as part of the restructuring of its regulation of natural gas companies. The majority opinion stressed repeatedly that it was not ordering the Commission to adopt a particular

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[11] In *AGD*, the court of appeals upheld the open access requirement of Order No. 436 pipelines, and the Commission has repromulgated this requirement intact. FERC Order No. 500, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Interim Rule and Statement of Policy, 52 Fed. Reg. 30,334 (August 14, 1987), III. F.E.R.C. Stats. & Regs. [Regs. Preambles] (CCH) ¶ 30,761 (1987).

remedy.[12] Rather, it was remanding because the Commission did not express its reasons "clearly enough for [the court of appeals] to determine the legality of its analysis." App. at 90a.

The Commission has not dissented from this course; it has not asked this Court to review the decision below or to relieve it from the judgment. To the contrary, it has instituted a new proceeding in which it intends to examine fully the extent of the take-or-pay problem and explore the need for additional Commission action.[13] It also has issued *interim* regulations that attempt in a limited way to restore the pre-Order No. 436 *status quo* insofar as take-or-pay build-up is concerned.[14] Under the circumstances, review of this aspect of the *AGD* decision below is unwarranted.

In light of the strong judicial policy against piecemeal review[15], the Court does not grant certiorari to review a non-final judgment such as a remand order in the absence of special circumstances that require the Court to intercede. *See Brotherhood of Locomotive Firemen v.*

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[12] App. at 90a, 92a, 94a and 124(a) ("We do not require that FERC reach any particular conclusion; we merely mandate that it reach its conclusion by reasoned decisionmaking." App. at 94a).

[13] As part of Order No. 500, *supra*, n.11, the Commission invited public comments on a range of permanent options to address the take-or-pay impact of open access transportation, and stated that it would use its statutory authority to collect comprehensive data on take-or-pay. F.E.R.C. Stats. & Regs. (CCH), *supra*, at 30,784, 30,799-800. The Producers have been and doubtless will continue to be active participants in that proceeding.

[14] The FERC Order No. 500 regulations provide, as an interim measure, that producers give open access pipelines volumetric credit against take-or-pay obligations for each Mcf of gas transported for that producer. *See* Order No. 500, *supra*, n. 11; Order Explaining Crediting Provisions, 41 F.E.R.C. (CCH) ¶ 61,025 (1987).

[15] *See, e.g.*, Olson v. Paine, Webber, Jackson & Curtis, Inc., 806 F.2d 731, 733 (7th Cir. 1986).

*Bangor & Aroostook Railroad Co.*, 389 U.S. 327, 328 (1967); *Hamilton-Brown Shoe Co. v. Wolf Brothers & Co.*, 240 U.S. 251, 258 (1916). No special circumstances warrant review of the court of appeals' remand on the take-or-pay issue. The facts and circumstances strongly counsel against premature review of the remand order.

First, Producers' petition does not challenge the legality of specific regulations or decisions of the Commission. Instead, Producers request the Court to issue an advisory opinion that the Commission has no authority whatsoever to mitigate the build up of take-or-pay caused by open access transportation under Order No. 436.[16]

Producers' legal challenge lacks the concreteness necessary for review by the Court.[17] For example, the court of appeals discussed generically, under the heading "conditioning producer access", proposals for mitigation of take-or-pay, which differed in their specific elements. App. at 91a. Some requested no more than a declaration by the Commission that it is not unduly discriminatory *per se* for an open access pipeline to negotiate and obtain take-or-pay credit equal to the quantity of gas that a producer wants to sell and have transported to the pipeline's tradi-

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[16] The Commission has not defended Order No. 436 on the ground that it lacked authority to take affirmative action to mitigate the take-or-pay problem. Although it suggested at one time that it might not have authority, it moved away from that position on rehearing and repudiated it in its brief to the court of appeals. App. at 93a. Thus, Producers objections at pages 9-15 of their petition go to the court of appeals' rejection of their attempt to support the Commission's order on grounds that the Commission did not rely on for its decision.

[17] The Court's opinion in Chevron, U.S.A. v. Natural Resources Defense Council, 467 U.S. 837 (1984), presumes that the agency will have provided an explication of its statutory authority in the first instance. Because of the context in which Producers' challenge arises, the Court does not have the benefit of an in-depth analysis by the Commission of its statutory authority to mitigate the impact of Order No. 436 on interstate pipelines.

tional sales customers. Others would have required producers to renegotiate above-market "problem contracts" with all interstate pipelines in order to obtain open access transportation on any pipeline's system. Obviously, these proposals would have very different impacts on the affected parties and implicate different values. Yet, Producers would have the Court condemn all possible actions by the Commission that might affect producer contracts without any consideration of the qualitative and quantitative difference of various proposals. If, on remand from the decision below, the Commission adopts final rules that adversely affect producer interests, they will have a full opportunity to contest the legality of the case-specific actions.[18]

Second, the outcome of the Commission proceedings on remand is hardly a foregone conclusion, and may eliminate Court review. In Order No. 500, the Commission did not exercise its authority under section 5 of the NGA to modify jurisdictional producer-pipeline contracts; nor did it broadly order producers to abrogate their above-market contracts or lower their prices under such contracts. The Commission adopted a limited, temporary remedy *pendente lite*. *See* FERC Order No. 500, *supra*, n. 11. Producers have filed comments in that proceeding which challenge the legality and wisdom of take-or-pay crediting, and the Commission has the matter under advisement.

Third, regardless of the outcome of the Commission's proceeding on remand, further judicial review will be based upon a far more complete record than the patently inadequate record in the Order No. 436 proceeding. The court of appeals rightly described the Commission's fac-

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[18] Several of the petitioners in No. 87-978 have appealed the interim take-or-pay crediting procedures of FERC Order No. 500 to the United States Court of Appeals for the Fifth Circuit. That proceeding provides an additional forum in which to contest in a concrete setting the Commission's exercise of its NGA jurisdiction.

tual assessment to be "utterly Panglossian." [19] After promulgating Order No. 436, the Commission admitted to Congress that it did not have the data to assess the extent of the existing take-or-pay problem.[20] On remand, the Commission has exercised its authority under the NGA and the NGPA to obtain data on the extent of the take-or-pay problem.[21] Correction of this glaring omission can only aid the administrative and judicial process.

## II. THE COURT OF APPEALS PROPERLY REMANDED THE PROCEEDING TO THE COMMISSION FOR FURTHER CONSIDERATION

In light of our strongly held belief that review by this Court is premature, we ordinarily would not address the question whether the remand order was correct on the

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[19] App. at 94a. *See* App. at 81a-84a ("FERC offers nothing to undermine the challengers' inherently plausible suggestion that [the Order No. 436 open access] conditions will have an adverse impact on the pipelines' take-or-pay problems.")

[20] In April, 1986, the Commission admitted in a letter to members of the Government Operations Committee of the House of Representatives, that it had very little idea of the extent to which pipeline operations had been or would be affected by actual or potential take-or-pay liability. The Commission stated that data submitted under current regulations "do not provide sufficient information to assess the current magnitude of these [take-or-pay] liabilities." The Members asked whether the Commission had solicited data with respect to take-or-pay obligations in the rulemaking and whether it had data to assess the extent to which Order No. 436 would increase pipelines' take-or-pay exposure. The Commission answered, "there are no data on the extent to which Order No. 436 may increase pipeline take-or-pay exposure." This letter is reprinted in the Supplemental Appendix to this brief.

[21] In FERC Order No. 500, *supra*, n.11, the Commission announced it was requiring each interstate natural gas pipeline company to respond to an extremely detailed data request "to determine the extent and nature of pipelines' take-or-pay obligations with respect to the various NGPA pricing categories." The Commission stated that it would "aggregate the data and analyze it promptly." F.E.R.C. Stats. & Regs. (CCH) at 30,784.

merits. However, Producers' petition could be construed to argue that the decision below is so obviously wrong that further proceedings are clearly unnecessary. We, therefore, demonstrate below that the court of appeals' decision is well grounded in law and policy.

### A. The Court of Appeals Correctly Affirmed the Commission's Authority Under the Natural Gas Act to Remove Barriers That Prevent the Efficient Functioning of Gas Markets

Producers argue that the *AGD* decision unjustifiably authorizes the Commission to deny "access to transportation for many producers. . . ." (Pet. Br. at 10) However, neither the NGPA nor the NGA mandate that interstate pipelines must transport gas sold by producers to pipeline sales customers in transactions that displace pipelines' sales and create take-or-pay liability. App. at 93a-94a. In Order No. 436, the Commission mandated open access as an exercise of its power to condition the authority of pipelines to transport gas under section 7 of the Natural Gas Act, 15 U.S.C. § 717e, and section 311 of the Natural Gas Policy Act, 15 U.S.C. § 3371. If the Commission's NGA and NGPA powers allow it to impose open access conditions on interstate pipelines,[22] then the Commission similarly may place qualifications on open access as a transitional measure to mitigate the build-up of take-or-pay costs and encourage the renegotiation of such barriers to the efficient operation of gas markets.

#### 1. *The Commission Has Plenary Jurisdiction Over The Transportation of Natural Gas*

Although the NGPA withdrew the Commission's authority to establish wellhead prices and to regulate so-called "first sales" of natural gas, it reaffirmed the Commission's plenary jurisdiction over the *transportation* of

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[22] Nos. 87-976, 87-977 and 87-979 seek Court review of the legality of the open access requirement.

natural gas pursuant to sections 1(b) and 7 of the NGA, 15 U.S.C. §§ 717(b), 717f, and section 311 of the NGPA, 15 U.S.C. § 3371.[23]

Any doubt as to the Commission's continuing plenary jurisdiction over interstate transportation is dispelled by the legislative history of the NGPA. The Explanatory Statement of the House Managers of the conference bill that became the NGPA emphasizes that:

> FERC retains its transportation certification authority under section 7 of the Natural Gas Act. The authority was relied upon by both FERC and its predecessor, the FPC, to impose a wide range of conditions upon the transportation of gas in interstate commerce. This authority remains intact . . . .[24]

Producers claim that the court of appeals ignored the limitations placed on the Commission's transportation jurisdiction by section 601(c)(1) of the NGPA, 15 U.S.C.

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[23] Section 1(b) of the NGA gives the Commission jurisdiction over (1) the transportation of natural gas in interstate commerce, (2) the sale for resale of natural gas in interstate commerce and (3) natural gas companies engaged in such sales or transportation. Each of these grants in an independent, albeit often overlapping fount of authority. FPC v. Louisiana Power & Light Co., 406 U.S. 621, 636 (1972); FPC v. East Ohio Gas Co., 338 U.S. 464, 468-69 (1950). In integrating the NGPA with the NGA, Congress actually expanded the Commission's jurisdiction over gas transportation. Pursuant to NGPA § 601(a)(2), 15 U.S.C. § 3431(a)(2), the Commission's *NGA* transportation jurisdiction was modified only with respect to the extraordinary presidential authority contained in NGPA §§ 302 and 303 and to acknowledge the additional grant of authority in NGPA § 311 over certain transportation by intrastate and interstate pipelines. Notably, § 311(c), in virtually the same terms as NGA § 7(e), authorizes the FERC to approve qualifying transportation arrangements "under such terms and conditions as the Commission may prescribe." 15 U.S.C. § 3371(c).

[24] 124 Cong. Rec. H13119. Notably, in their brief to the court of appeals (at 20), Producers described the Explanatory Statement as the "strongest type of legislative interpretation."

§ 3431(c)(1).[25] However, producers did *not* argue below that Section 601(c)(1) placed substantive limits on the Commission's authority to mitigate the impact of Order No. 436 on pipeline take or pay. Section 601(c)(1) is irrelevant to the access condition considered in *AGD*. By imposing an access condition, the *Commission* would *not* be denying any pipeline the right to apply for and receive a certificate to transport for any person "based upon the amount paid in any sale of gas."[26] Rather, such a condition would allow a *pipeline* to obtain reasonable take-or-pay relief (as defined by the Commission) from those producers that want the privilege of gaining access to the pipeline's system. As the court of appeals correctly observed, neither the NGA nor the NGPA mandate that producers be granted unfettered access to interstate transportation and enjoy the new market opportunities thereby created. App. at 93a-94a.

An access condition is fully consistent with the Congressional intent of the NGPA. While Congress envisioned that wellhead prices would be determined by market forces, it was legislating against a background in which the buyers in that market consisted largely of interstate pipelines. Order No. 436 fundamentally changes market conditions and benefits producers by adding new buyers to the market. The decision below recognizes that the NGA and NGPA do not require the Commission to create new market opportunities for producers. An ac-

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[25] Section 601(c)(1) provides under the heading "Guaranteed passthrough" that: "The Commission may not deny, or condition the grant of, any certificate under Section 7 of the Natural Gas Act based upon the amount paid in any sale of natural gas, if such amount is deemed to be just and reasonable. . . ."

[26] Subsequent to the NGPA and prior to Order No. 436, the Commission routinely attached conditions to certificates which limited the gas eligible for transportation (including limitations based on price) without serious challenge to their validity. *See, e.g.*, Tenneco Oil Co., 29 F.E.R.C. (CCH) ¶ 61,334 at 61,700 (1984); Tenneco Oil Co., 26 F.E.R.C. (CCH) ¶ 61,030 at 61,072 (1984).

cess condition, such as take-or-pay crediting, allows pipelines to make the transition to these new market circumstances.

### 2. *The NGPA Does Not Bar The Commission's Exercise Of its Authority To Modify Non-Price Terms In Jurisdictional Contracts*

In the NGPA, Congress removed certificate jurisdiction over producer-pipeline sales of "new" and price-deregulated gas.[27] But it retained certificate jurisdiction—and, hence, NGA § 5 authority[28]—over producer-pipeline sales of so-called "old" gas. The court of appeals described this as "perfectly standard grandfathering." App. at 90a.

Producers nonetheless contend that the Commission is prohibited from exercising its NGA § 5 authority to mitigate high take-or-pay provisions in *jurisdictional* producer-pipeline contracts because such provisions interact with contractual price provisions to prevent the efficient functioning of the gas market.[29] But such authority, if

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[27] Section 601(a)(1), of the NGPA, 15 U.S.C. § 3431(a)(1), sets forth the categories of gas sales that are no longer subject to NGA sales jurisdiction.

[28] Section 5 of the NGA, 15 U.S.C. § 717d, provides in pertinent part that whenever the Commission finds that "any rule, regulation, practice or contract" subject to its transportation or sales jurisdiction "is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable . . . rule, regulation, practice or contract to be thereafter observed and in force, and shall fix the same by order . . . ."

[29] Pennzoil Co. v. FERC, 645 F.2d 360 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982), cited at page 12 n.33 of Producers petition, is inapposite. That case dealt only with the question of the Commission's authority to interpret the rate-setting provisions of *non-jurisdictional contracts*—those contracts that Congress removed from the Commission's NGA sales certificate jurisdiction. Nor does Office of Consumer Counsel v. FERC, 783 F.2d 206 (D.C. Cir. 1986) (cited at page 10 n.25 of Producers' petition) support Producers' claim. To the contrary, the court of appeals upheld a

exercised,[30] would not prescribe price levels or require producers to charge any particular price. Above-market contract prices are problematic only where the contract requires the pipeline to take or pay for the gas without regard to market price. The Commission found in Order No. 436 that such take-or-pay provisions prevent the development of an efficient, competitive market for natural gas at the wellhead.[31]

By reducing to just and reasonable levels the maximum obligations of pipelines to take gas under jurisdictional contracts entered into during the gas shortage, the Commission would be creating *market conditions* which allow *market forces* to determine whether the contract price is too high. Thus, a Commission decision to exercise its NGA § 5 authority to modify non-price provisions in pre-NGPA contracts over which it has jurisdiction because they impede the transition to a competitive market would be fully consistent with the specific language of section 5 and with Congressional intent. *Cf. Conway Corp. v. FPC*, 510 F.2d 1264, 1270-72 (D.C. Cir. 1975), *affirmed*, 426 U.S. 271, 279 (1976).

### B. In Remanding the Case to the Commission the Court of Appeals Correctly Applied the Arbitrary-and-Capricious Test

Invoking this Court's *Chevron* decision,[32] Producers accuse the court of appeals of failing to defer to the Com-

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Commission finding that certain take-or-pay clauses in producer-pipeline contracts had become unjust and unreasonable under section 5 of the NGA.

[30] Again, Producers challenge is hypothetical. The court of appeals did not direct the Commission to exercise its NGA § 5 power and the Commission has not done so.

[31] The court of appeals observed that "the Commission itself has identified the producer-pipeline contracts as a primary cause of the problem that Order No. 436 is intended to cure." App. at 91.

[32] Chevron, U.S.A. v. Natural Resources Defense Council, *supra*, 467 U.S. 837.

mission's decision. However, *Chevron* should not become "a talisman under which any agency decision is by definition unimpeachable." *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 50 (1983) (*"State Farm"*). Producers do not raise any issues of administrative law that require the Court to exercise supervisory authority over the court below. The Commission has neither complained that its authority has been usurped nor sought Court review of the remand order. Review is sought by those who would take advantage of the market opportunities of Order No. 436 to sell less expensive "spot market" gas into traditional pipeline sales markets and require pipelines to take or pay for more expensive long-term gas supply acquired to meet their sales obligations under certificates issued by the Commission.

In remanding the case to the Commission, the court of appeals properly applied this Court's teaching in *State Farm* to set aside arbitrary and capricious agency action. *Id.* at 42-43. The court of appeals correctly identified the three premises upon which the Commission's refusal to act was based: (1) Order No. 436 would not cause take-or-pay liabilities to increase; (2) certain policy considerations militated against regulatory relief; and (3) the most prominent remedies (exercise of NGA § 5 power to modify unjust and unreasonable take-or-pay provisions; and limitations on open access where producers refuse to cooperate in mitigating the impact of Order No. 436 on pipeline take-or-pay) were flawed. App. at 80a. It remanded Order No. 436 because the first and third premises were wholly insupportable. App. at 81a-86a, 89a-94a.

The court of appeals explained in great detail why it could not accept the Commission's assertion that Order No. 436 would not increase pipeline take-or-pay exposure and make the resolution of these liabilities more difficult and expensive. App. at 80a-86a. It concluded that

"FERC's seeming blindness to the possible impact of Order No. 436 on take-or-pay liability . . . seem[s] impossible to square with the requirement of reasoned decisionmaking." App. at 84a. The Court's analysis is amply supported by the Commission's subsequent admission that it had no reliable information on the extent of the take-or-pay problem and its action in Order No. 500 to obtain this critical data.[33] Producers do not attempt to rebut the court's careful analysis, but instead offer various excuses for the Commission's "utterly Panglossian" factual assessment. But reasoned decisionmaking requires more than a "minimum rationality." *State Farm, supra,* 463 U.S. at 42 n.9. The court of appeals was not required to accept uncritically an explanation that "runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Id.* at 43.[34]

The court of appeals also identified fatal weaknesses in the reasons offered by the Commission for rejecting the significant alternatives to its no-action course. App. at 89a-94a. It found the Commission's explanation of the reasons for its rejection of Section 5 action to be so unclear and lacking in content that the legality of the Commission's analysis could not be reviewed. App. at 90a. While remanding for further consideration, the majority opinion even suggested possible justifications to the Commission in support of its refusal to exercise its section 5 power. *Id.* This is hardly indicative of a court whose purpose and intent is to substitute its judgment for the agency's.

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[33] *See* n.20 & 21, *supra,* and accompanying text.

[34] Nor can the Commission's actions be defended by arguing that the dimensions of the take-or-pay problem were uncertain. It was incumbent upon the Commission to explain the reason why it was necessary to act without "engaging in a search for further evidence." State Farm, *supra,* 463 U.S. at 52.

The court of appeals similarly found implausible the Commission's primary reason for refusing to consider some form of take-or-pay relief in return for giving producers the privilege of access to pipeline systems—the claim that such a refusal would always be unduly discriminatory. The court stated:

> Given that the Commission itself has identified the producer-pipeline contracts as a primary cause of the problem that Order No. 436 is intended to cure, it eludes us why pipeline denial of access to producers that stand on the letter of their contract rights should be viewed as unduly discriminatory. It is clear that § 5 does not prohibit every distinction. FERC offers no reason why it views this one as beyond the pale.

App. at 91a-92a (citations omitted).

Producers again do not address the court of appeals analysis; they merely repeat the Commission's claim that any policy other than unrestricted access to interstate transportation is unduly discriminatory, and cite the other policy considerations raised by the Commission. (Pet. Br. at 18-19) But the court of appeals was not required to speculate whether the Commission's other policy considerations would tip the scales in favor of nonintervention in the absence of an unjustified concern that restricting access would be unduly discriminatory on its face. It properly remanded in order to allow the Commission to determine "to what extent these policy considerations may justify its inaction on the uneconomical producer-pipeline contracts." App. at 94a.

## III. THE COURT SHOULD NOT RENDER AN ADVISORY OPINION ON THE SCOPE OF THE STATES' JURISDICTION OVER THE INTERSTATE TRANSPORTATION OF NATURAL GAS

SoCal's petition in No. 87-1091 challenges the Commission's authority to adopt Optional Expedite (OEC) procedures to process applications for certificates. In decid-

ing whether to issue an OEC, the Commission stated it would not consider factors that have traditionally been used to justify denial of certificates—particularly duplication of facilities and the impact on the LDC of transactions in which interstate pipelines propose to transport gas directly to end-users without utilizing the facilities of the local distribution company (the so-called "bypass issue"). *See* App. at 102a.

In Part III of its petition, SoCal argues that the Court must review the *AGD* decision in order to declare that the states have the authority to regulate the interstate transportation of gas by an interstate pipeline at some point prior to the point at which the gas is received by the customer. SoCal claims this jurisdictional issue is ripe for review because the Commission and the court of appeals relied on the existence of the authority of the states to regulate such interstate transportation of gas, and establish their own certification standards, to determine that the Commission could change its certification policies. (SoCal Br. at 11) Tennessee opposes SoCal's request for clarification.

SoCal's argument concerning the need to "clarify" the scope of state jurisdiction rests on a fundamental misreading of Order No. 436 and the *AGD* decision. *AGD* did not uphold the OEC regulations on the ground that the states have comparable authority to impose their own certification requirements and veto or re-arrange a transportation proposal that would bypass an LDC. The Commission and the court of appeals concluded that where the applicant for a certificate must assume the full economic risk of the venture, the risk of wasteful bypass is remote.[35] While the Commission in Order No. 436 and

[35] App. at 104a. The court explained in detail that the risk of bypass largely is a function of *rate* policies established by state regulatory agencies that allow LDCs to extract from disfavored customers "a disproportionate share of [the LDC's] costs." App. at 106a.

the court in *AGD* referred to the authority of the states to control direct sales,[36] neither Order No. 436 nor the *AGD* decision purport to establish the bounds of state jurisdiction. The court of appeals stated that: "The exact scope of this power is unplumbed and is not before us now." App. at 106a.

The Court does not have before it an actual case or controversy in which the FERC has issued a certificate to an applicant for the interstate transportation of gas into a state over the objection of a state agency which maintains that it has jurisdiction to regulate the transaction. SoCal asks this Court to venture an advisory opinion without a specific factual anchor and the detailed maps provided by agency and appellate decisions concerning the respective Constitutional and statutory allocation of regulatory authority between the FERC and state regulatory agencies. This is "too remote and abstract an inquiry for the proper exercise of the judicial function." *International Longshoreman's and Warehouseman's Union, Local 37 v. Boyd*, 347 U.S. 222, 224 (1954).

The issue before the Court is not whether the Commission's decision to de-emphasize certain factors in certificate proceedings is justified because the states can assume the regulatory mantle; the issue is whether the Commission can properly de-emphasize these factors

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[36] App. at 106a. *See* Panhandle Eastern Pipe Line Co. v. Michigan Public Service Comm., 341 U.S. 329 (1951). Under the NGA, the Commission's sales jurisdiction extends only to sales for resale. *Panhandle* involved an exercise by the states of their authority to regulate direct sales, that is, sales for ultimate consumption. By contrast, the Commission's jurisdiction over interstate transportation is plenary. The Commission has ruled that the transportation and delivery of gas by an interstate pipeline to a customer is not "local distribution" of natural gas subject to state jurisdiction Mojave Pipeline Co., 35 F.E.R.C. (CCH) ¶ 61,199 (1986), *rehearing denied*, 41 F.E.R.C. (CCH) ¶ 61,040 (1987), *appeal pending*, Public Utilities Comm. on California v. FERC, No. 87-1679 (D.C. Cir.).

where the applicant has agreed to accept conditions which subject new services to the discipline of the marketplace. The resolution of the issue properly before the Court does not depend on the existence *vel non* of state regulatory authority.

## CONCLUSION

The petitions for a writ of certiorari in Nos. 87-978 and 87-1091 should be denied.

Respectfully submitted,

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March 16, 1988

# SUPPLEMENTAL APPENDIX
# TO
# BRIEF IN OPPOSITION

***Letter to Honorable Frank Horton, from Acting FERC Chairman Anthony G. Sousa, April 23, 1986***

## SUPPLEMENTAL APPENDIX

FEDERAL ENERGY REGULATORY COMMISSION
Washington, D.C. 20426

April 23, 1986

Honorable Frank Horton
House of Representatives
Washington, D.C. 20515

Dear Mr. Horton:

Thank you for your letter of March 18, 1986, in which you expressed your concern about the effect of take-or-pay provisions in natural gas contracts and the Commission's issuance of Order No. 436. Your letter posed eight questions to me regarding take-or-pay. My response to your inquiry is as follows.

(1) Are we correct that the FERC, and its predecessor the FPC, required a showing of a long term supply of gas as well as a long term market for the gas prior to authorizing transmission companies to construct and operate their proposed facility?

Under section 7(c) of the Natural Gas Act (NGA), pipeline companies seeking to initiate service or seeking to serve major new markets must show that their source(s) of supply are adequate to meet the needs of the new or expanded market. One measure of gas supply is "deliverability life," expressed in terms of the number of years a pipeline can meet its current annual requirements using the relevant source(s) of supply, given the certificated delivery capacity of the pipeline. Until the late 1960's, pipelines seeking Commission authorization to commence new or expanded service were required to show that their source(s) of supply had a minimum twelve-year deliverability life. The Commission adopted a more flexible policy in 1967, (18 C.F.R. § 2.61) which

had the effect of eliminating the requirement of a specific deliverability showing where (a) a pipeline had active gas procurement operations and (b) a pipeline's system extended into active production areas. The Commission's current policy is to review all applications for new or expanded service filed under section 7(c) of the NGA on a case-by-case basis to determine if an adequate supply of gas is available to support the application.

(2) Are we correct in assuming that your regulations require that the pipelines sell the gas to their distributor company customers at the same price that they buy it from the producers plus the cost of transportation from the production area to the market area?

Generally, a pipeline is not permitted to sell gas for more than the purchase price. Furthermore, under section 601 of the Natural Gas Policy Act of 1978 (NGPA), pipelines are guaranteed the right to passthrough their purchased gas costs to their customers to the extent the amount paid is just and reasonable and not excessive due to fraud, abuse, and similar grounds. Also included in a pipeline's cost of service are costs attributable to production, storage and transmission.

(3) Do most of the contracts between pipeline companies and the producers contain take-or-pay clauses?

Contracts for the sale of natural gas have traditionally contained provisions requiring the purchaser to take-or-pay for specified quantities of gas and the vast majority of current gas contracts contain take-or-pay provisions. Most contracts also contain a 5-year make up period in which producers are obligated to maintain the ability to deliver the gas paid for but not taken.

(4) What is the *current* magnitude of these liabilities?

The data submitted under our current regulations do not provide sufficient information to assess the current magnitude of these liabilities.

It is important to distinguish between actual prepayments made for gas not taken and a pipeline's potential take-or-pay liability under its contracts. Payments made before the expiration of the make up period are prepayments. Prepayments are treated as an asset of the pipeline and are added to the pipeline's rate base, along with any interest incurred by the pipeline to finance its prepayments. In some cases, a pipeline may not be able to market its prepaid gas during the make up period and, since prepayments are not purchased gas costs, the pipeline cannot automatically passthrough its prepayments.

A pipeline's take-or-pay liability is not suspectible to accurate estimate, because it is difficult to estimate the extent to which a pipeline will be unable to take gas during the make up period for which it has already paid or will be required to pay, and therefore for which it may become legally "liable." In addition, estimates are based on current levels of purchases and projected market demand, each of which may change during the make up period. Some pipelines include a discussion of their take-or-pay problems in their annual reports and Form 10-K quarterly reports filed with the Securities and Exchange Commission (SEC). As of November 1985, actual take-or-pay prepayments included in the rate base of major pipelines totalled approximately $650 million as computed by the FERC.

(5) It is our understanding that there is a significant delay between the time a pipeline incurs this liability and when they make payments. If this is correct, explain this delay. How does your response to question four above recognize this delay, if in fact it occurs?

Typical take-or-pay clauses define the "take" requirement in terms of a specific volume of gas which must be taken by the pipeline within a specific period of time, usually the contract year. The Commission does not impose specific reporting requirements on pipelines to moni-

tor take-or-pay payments and may learn of a pipeline's prepayments for the first time when a pipeline attempts to recover its costs and files its next rate case. Nothing in the Commission's regulations prevents a pipeline from making take-or-pay payments as soon as it contractually incurs them. To some extent, the estimates provided in response to question number four reflect this delay. To a greater extent, however, the imprecise quantification of take-or-pay liability can be traced to the historic and present reluctance of both pipelines and producers to make this information available, especially with respect to gas purchase contracts for gas not subject to the Commission's jurisdiction.

(6) In your notice of RM85-1 did you solicit information on current magnitudes of pipeline take-or-pay exposures? Was it provided with any degree of specificity? Does the Commission have any data on the extent to which Order Nos. 380 and 436 will increase pipelines' take-or-pay exposure? If so, what does this data reflect?

Over the last four years, the Commission has initiated several rulemaking proceedings in which take-or-pay has been an issue. In two recent proceedings (Docket Nos. RM85-1-000 and RM86-3-000), various members of the different segments of the industry have presented conflicting views on the magnitude of the take-or-pay problem.

At the moment, there are no data on the extent to which Order No. 436 may increase pipelines' take-or-pay exposure. We do know that take-or-pay prepayments have remained stable or declined slightly between 1982 and 1985.

(7) It is our understanding that the pipelines have not overwhelmingly availed themselves of Order No. 436 provisions. Please furnish the names of those companies who have availed themselves of the provisions. Has the implementation of the open access provision by these com-

panies been acceptable to their customers and their traditional suppliers? What impact has pipelines' increased take-or-pay exposure had on their decision to operate under Order No. 436?

The following companies have made blanket certificate or rate settlement filings under Order No. 436: Gas Gathering Corporation, Valley Gas Transmission, Inc., Mid Louisiana Gas Company, Columbia Gulf Transmission Company, Columbia Gas Transmission Corporation, Ozark Gas Transmission System, Gas Transport, Inc., Valero Interstate Transmission Company, Consolidated Gas Transmission Corporation, Erie Pipeline System, Seagull Interstate Corporation, Texas Eastern Transmission Corporation, Superior Offshore Pipeline Company, Northern Border Pipeline Company, Transcontinental Gas Pipeline Company, Transco Offshore Gathering Company, Transwestern Pipeline Company, and El Paso Natural Gas Company. In addition, many of these companies and others have provided self-implementing transportation services on an interim basis under Order No. 436 and section 311 of the Natural Gas Policy Act of 1978.

Since companies have only recently begun to transport gas pursuant to Order No. 436, it is too early to determine whether their participation has been acceptable to their customers and their suppliers. It is also difficult to determine whether and to what extent take-or-pay exposure has influenced pipelines' decisions on participation in Order No. 436.

(8) Are you aware of any pipeline companies whose financial abilities may be impaired by take-or-pay liabilities?

It is difficult to determine whether any pipelines have been financially impaired because of their take-or-pay liability. This may be discussed in filings made by pipe-

line companies with the Securities and Exchange Commission and in annual reports.

I hope this information is helpful to you. If I can be of further assistance to you in this or any other Commission matter, please let me know.

Sincerely,

/s/ Anthony G. Sousa
ANTHONY G. SOUSA
Acting Chairman